(33)

IN THE

Supreme Court of the United States

OCTOBER TERM, 1943.

ROBERT W. JOHNSTON, *Petitioner,* *vs.* COMMISSIONER OF INTERNAL REVENUE.	No. 1080
T. ALICE KLAGES, *Petitioner,* *vs.* COMMISSIONER OF INTERNAL REVENUE.	No. 1081

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

The petitioners respectfully pray that writs of certiorari issue to review the judgments of the United States Circuit Court of Appeals for the Second Circuit entered in the above-entitled causes on March 10, 1944 affirming orders of the Tax Court of the United States entered February 10 and February 13, 1943, respectively, determining a deficiency in each petitioner's federal tax liability for the calendar year 1937 in the amount of approximately $15,600.

Opinions Below.

The opinion of the United States Circuit Court of Appeals in both cases is reported in 141 F. (2d) 208 (J 59; K 55).* The opinion of the Tax Court in both cases is reported in 1 T. C. 228 (J 19; K 15).

Jurisdiction.

The statutory provisions believed to sustain the jurisdiction of this Court are Sec. 1141 of the Internal Revenue Code and Sec. 240(a) of the Judicial Code as amended (28 U. S. C. Sec. 347).

Question Presented.

The question is the same in both cases. It is whether, after the sale by trustees, at a loss, of improved real estate previously acquired through the foreclosure of a bond and mortgage owned by the trust, that portion of the net proceeds of the sale to which the petitioners, the income beneficiaries of the trust, became entitled under the applicable rule of law of the State of New York, was income, taxable to the petitioners under the provisions of the Revenue Act of 1936 and of the Sixteenth Amendment to the Constitution of the United States.

Statutes Involved.

The following are the pertinent sections of the Revenue Act of 1936:

"SEC. 22. GROSS INCOME.

(a) General Definition.—'Gross income' includes gains, profits, and income derived from salaries,

* "J" refers to the Johnston record and "K" to the Klages record; as all material facts and the opinions below are the same in both cases, actual reference is necessary to only one of the records.

wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

"(b) Exclusions from Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this title: * * *

"(3) Gifts, Bequests, and Devises.—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income); * * *

* * * * * *

"SEC. 161. IMPOSITION OF TAX.

(a) Application of Tax.—The taxes imposed by this title upon individuals shall apply to the income of estates or of any kind of property held in trust, including——

* * * * * *

"(2) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

* * * * * *

"(b) Computation and Payment.—The tax shall be computed upon the net income of the estate or trust, and shall be paid by the fiduciary, * * *"

"SEC. 162. NET INCOME.

The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that——

* * * * * *

"(b) There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries, * * * but the amount so allowed as a deduction shall be included in computing the net income of the beneficiaries whether distributed to them or not. * * *"

Statement.

These two cases present exactly the same question which arises out of identically the same facts. Any decision with respect to one must necessarily control the other and presentation of two petitions in separate form would be repetitious and not in the interests of brevity.

The petitioners were the income beneficiaries of two trusts created by a single deed of trust and administered by the same trustees (J 23; K 19).

On default in interest payments the trustees foreclosed a bond and mortgage owned by the trusts and at the foreclosure sale in December, 1932, bid in the mortgaged premises for the trusts for $600,000, the amount of unpaid principal (J 25; K 21).

On January 11, 1937 the trustees sold the property so acquired for $550,000, receiving $100,000 in cash and a purchase money bond and mortgage in the principal amount of $450,000 (J 26; K 22). This sale concededly resulted in a loss to each trust which was reported on the fiduciary income tax returns filed by the trustees (J 27; K 23).

The trustees in 1937 apportioned the net sale proceeds, including the bond and mortgage at par, between the income beneficiaries and trust principal in the ratio which the amount of unpaid interest on the foreclosed mortgage

(computed at the stipulated mortgage rate from date of last payment to the date of sale) bore to the amount of unpaid principal. Accordingly, approximately 21% of the sale proceeds was allocated to the petitioners; in each case this amounted to about $57,600 (J 27-28; K 23-24). This apportionment was pursuant to the rule* established by the New York courts in *Matter of Chapal*, 269 N. Y. 464, 199 N. E. 762, and *Matter of Otis*, 276 N. Y. 101; 11 N. E. 2(d) 556 (J 29; K 25).

For the purposes of these applications, said amounts, as in the court below, are treated as having been paid or credited in 1937 to each petitioner out of the sale proceeds.

The respondent included these allocated amounts in the 1937 taxable income of each of the petitioners (J 21; K 17), which action gave rise to the tax deficiencies here in controversy.

Rulings of the Courts Below.

The Tax Court of the United States, on appeals by both petitioners, sustained the respondent (three judges dissenting), and held that the amounts were taxable income under Sec. 162(b) of the Revenue Act of 1936, but if not under that section, then taxable under Sec. 22(a) (J 41; K 37).

Both petitioners sought review by the Circuit Court of Appeals for the Second Circuit. That court unanimously affirmed the orders of the Tax Court (J 66; K 62).

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* This rule as affected by later legislation was before this Court in *Demorest, Jr.* vs. *City Bank Farmers Trust Co., et al.*, ... U. S. ....; 64 S. Ct. 384.

Assignments of Error.

1. The Circuit Court erred in holding that the portion of the sale proceeds to which the petitioners became entitled was taxable income to the petitioners.

2. The Circuit Court erred by giving controlling effect to a local rule of law in New York as against federal law in the determination of whether the amounts in question were taxable income.

3. The Circuit Court erred in affirming the orders of the Tax Court.

Reasons for Granting the Writs.

1. The decision of the Circuit Court involves the fundamental concept of what is to be regarded as income for federal tax purposes, particularly in connection with trust estates. Under the decision, although the sale proceeds represented a loss to the trusts, and although under Section 162(b) the petitioners were taxable only on trust income currently distributable to them, nevertheless the petitioners' share of those proceeds, acquired under a local rule of law, was held to be taxable income to them.

The decision also involves the question of the effect to be given to the local rule of law in the determination of what is income under federal tax law.

In at least six states other than New York similar apportionment rules are applied in so-called salvage operations, which, due to many mortgage defaults, have been and will be of frequent occurrence in the administration of numerous trust estates.*

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* Massachusetts, Maine, Rhode Island, New Jersey, Tennessee and Pennsylvania (Citations, note (1), p. 11 of brief). Inquiries to several large trust companies in New York City alone indicate thousands of trusts in their charge which are or will be affected by the decision in these cases.

Whether the amounts allocated to the petitioners can be regarded as taxable income under Sections 162(b) or 22(a) of the Revenue Act, or, indeed, under the Sixteenth Amendment to the Constitution of the United States, is, therefore, an important question of federal law which has not been, but should be, settled by this Court.

2. In these cases the trusts had no income; the apportioned proceeds were realized on a sale at a loss to the trusts (J 27; K 23). If the Circuit Court regarded the sale proceeds as "income" to the extent of the petitioners' share therein, its decision probably conflicts with the concept of "income" expressed by this Court in *Eisner* v. *Macomber*, 252 U. S. 189, 206, 207; 40 S. Ct. 189.

What was allocated to the petitioners was a part of trust principal, and it retained its non-taxable character in their hands. The decision in this respect conflicts with *Helvering* v. *Falk*, 291 U. S. 183; 54 S. Ct. 353.

Because the petitioners received something from the trusts, it does not follow that what they received was trust income, or income to them even if not trust income. In this respect it is difficult to reconcile the decision in principle with *Burnet* v. *Whitehouse*, 283 U. S. 148; 51 S. Ct. 374, and *Helvering* v. *Butterworth*, 290 U. S. 365; 54 S. Ct. 221.

Principles of federal law control in the determination of whether the amounts here involved were income under the Revenue Act and the Sixteenth Amendment, regardless of how the New York Courts may choose to treat them for equitable purposes. In purporting to follow the local rule and decisions which have no counterpart in federal tax law, the Circuit Court erred. *Lyeth* v. *Hoey*, 305 U. S. 188, 193; 59 S. Ct. 155; *Burnet* v. *Harmel*, 287 U. S. 103, 110; 53 S. Ct. 74.

The Circuit Court, therefore, has decided a federal question in a way probably in conflict with applicable decisions of this Court.

3. The Circuit Court's decision probably conflicts with the decisions of local courts. It erroneously assumed that the Chapal-Otis rule constituted the petitioners "lienors upon the land" to the extent of the unpaid interest on the foreclosed mortgage (J 65; K 61) and, apparently, that the sale proceeds were regarded as trust income to the extent of the petitioners' share therein (J 64; K 60). The decisions of the local courts, however, negative the correctness of such assumptions. *Martin's Estate*, 165 Misc. 597, 609-610, 1 N. Y. S. (2d) 80; *In re Renn's Will*, 42 N. Y. S. (2d) 400 (Surrogates Court; not officially reported).

For the above reasons, it is respectfully submitted that a writ of certiorari should issue in each of these cases.

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